

No. 12,456

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**In the United States Court of Appeals  
for the Ninth Circuit**

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ESTATE OF R. L. LANGER, DECEASED, ELEANORE LANGER,  
EXECUTRIX, ELEANORE LANGER, C. ABBOTT LINDSEY  
AND PAULINE LINDSEY, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

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ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX  
COURT OF THE UNITED STATES

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**BRIEF FOR THE RESPONDENT**

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**FILED**

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PAUL P. O'BRIEN, JR.



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**OPINION BELOW**

The findings of fact and opinion of the Tax Court (R. 85-97) are reported at 13 T. C. 419.

**JURISDICTION**

This petition for review (R. 102-105) involves federal income taxes for the taxable years 1944 and 1945. On September 24, 1947, and February 19, 1948, the Commissioner of Internal Revenue mailed to taxpayers notices of deficiency in the total amount of \$16,002.32. (R. 6-9, 16-19, 26-31, 50-55.) Within ninety days, respectively, thereafter and on December 17, 1947, and May 11, 1948, taxpayers filed peti-

tions with the Tax Court for redetermination of the particular deficiency asserted against each under the provisions of Section 272 of the Internal Revenue Code. (R. 2-9, 11-19, 20-31, 44-55.)\* The decisions of the Tax Court affirming the Commissioner's determination of deficiency were entered September 29, 1949. (R. 98, 99, 100, 101.) This case is brought to this Court by a petition for review filed December 6, 1949 (R. 102-107), pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

#### QUESTION PRESENTED

Where an insolvent corporation, wholly owned by its officers and their families, was in default on the payment of a note secured by a deed of trust on its principal asset, and after procuring advances from and concessions on its note from its creditor, deferred payment of officers' salaries until first realizing an operating profit, was the deferment of salary payments such as to bring the salaries, when paid, within the operation of Section 107 (d) of the Internal Revenue Code?

#### STATUTE AND REGULATIONS INVOLVED

These may be found in the Appendix, *infra*.

#### STATEMENT

R. L. Langer, deceased, and his widow, Eleanore Langer, filed separate tax returns at Los Angeles, California, for 1944. Langer died July 6, 1948, his widow being appointed executrix, and as such was

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\* Page 55 of the printed record reads that one of the petitions for a redetermination of deficiency was filed May 11, 1949. A check of the docket entries in the Tax Court reveals that this is a typographical error, the correct date of filing being May 11, 1948.



substituted for him in the action brought by him below. (R. 87.)

Langer and family and Lindsey and family each owned one-half of the outstanding stock of the Commodore Hotel Company, a California corporation which operated the Commodore Hotel in Los Angeles. The corporation kept its accounts and filed its tax returns on the cash basis. Langer was president, Lindsey secretary, and by a resolution of the board of directors of April 14, 1937, a salary of \$600 a month was to be paid to each from January 1, 1937, and every month thereafter. Each was paid a total of \$4,800 during 1937, but because of financial difficulties no further payments were made until 1942 or 1943. From 1933 to 1942 the corporation each year sustained operating losses, which reached a maximum of \$14,724.74 in 1939, and its balance sheets constantly indicated a deficit until 1946, reaching a maximum deficit of \$63,867.69 in 1941. (R. 88.)

In 1933 the corporation had placed a deed of trust on its hotel building and a chattel mortgage on the furnishings, its principal assets, to secure its 6% note for \$241,581, payable in monthly instalments of \$2,000. By 1937 it was not only delinquent in the payment of interest on the note to the extent of \$13,419, but the creditor had advanced funds for taxes on the hotel. On January 16, 1937, an agreement was reached with the then holder of the note, Pacific Mutual Life Insurance Company, whereby the corporation agreed to pay off the total due of \$255,000 with interest over a ten year period in monthly instalments beginning at \$500 and increasing to \$1,250. The corporation made the required payments with some delays until June 30, 1939, but Pacific had to make further advances for taxes and by the end of August, 1941, the amount due Pacific had only been reduced to \$240,750. On Septem-

ber 16, 1941, Pacific and the corporation entered into a new agreement, reducing the interest on the balance to 5% and extending the payment period to 1956. The corporation agreed to make a fixed monthly payment of \$1,400 and to pay 50% of its net income to Pacific within thirty days of the end of each year. Net income for this purpose was defined as gross income less \$5,000, operating expenses "including usual and reasonable management charges", upkeep costs, taxes, interest and the principal payments on a second note for \$2,592.62 which the corporation gave to Pacific. This second note was paid off in 1942, and payments have since been made on the principal indebtedness substantially as required. Pacific refrained from foreclosing on the hotel because its officers felt that the corporation's properties were being capably and honestly handled and that Langer and Lindsey would ultimately work out their difficulties. (R. 88-89.)

At a director's meeting held January 2, 1942, Langer, the president, brought up the subject of officers' salaries and the repayment of a \$2,000 loan which he and Lindsey had each made to the corporation. Payment of the salaries and loans was authorized "as soon as there is sufficient net money available", and in the event of nonpayment of the salaries, authority was voted the officers "to execute the Corporation's promissory note to pay said sums at a later date \* \* \* when the assets of the Corporation will permit." On January 2, 1943, the salaries of the president and secretary were again set at \$600 per month for the current year, and the amounts were paid in that year. (R. 89-90.)

After the corporation realized an operating income of \$9,755.23 in 1942 and of \$24,666.17 in 1943, the board of directors on January 3, 1944, mentioning that some salary payments were made in 1942, authorized the payment of back salaries to the officers, and recognized



that there was owing to each \$1,200 for 1937 (later corrected to \$2,400); \$7,200 for each of the years 1938, 1939, 1940, 1941, and \$3,900 for 1942. They then resolved that the corporation pay all back salaries as soon as able to do so. (R. 90.)

Accordingly, Langer and Lindsey were each paid \$17,200 in 1944; Lindsey was paid an additional \$18,700 in 1945. Of the 1944 payments, \$10,000 to each was on account of back salary; of the 1945 payments \$11,500 was on account of back salary to Lindsey. Near the close of 1944 the directors instructed Langer to address the Salary Stabilization Unit of Treasury a letter requesting permission to pay officers' salaries for prior years. The Unit replied that payment of back salaries did not require its approval, "provided there was a bona fide contractual liability on October 3, 1942". (R. 90-91.)

At a directors' meeting December 5, 1945, the president was specifically authorized to pay \$3,000 of surplus on account of officers' back salaries. (R. 91.)

On their separate income tax returns for 1944 Langer and wife and Lindsey and wife each reported \$5,000 as the community share of the \$10,000 paid as back salary to each husband in 1944, and each computed a tax on this share by reference to rates applicable to years for which the salary was paid, invoking the benefits of Section 107 (d) of the Internal Revenue Code. Similarly, Lindsey and wife sought to apply Section 107 (d) with respect to their tax liability for 1945. As to each taxpayer, the Commissioner determined that Section 107 (d) was not applicable, and, adding the amounts received as back salary to other income reported, he recomputed the tax at the rates in effect for the years of receipt. (R. 92-93.)

The Tax Court, on taxpayers' petitions for a redetermination of the deficiencies thus determined, affirmed

the Commissioner's determinations. (R. 93-97.) Taxpayers now bring this consolidated appeal.

#### SUMMARY OF ARGUMENT

The Tax Court correctly held that there was not present herein a situation wherein salary payments were deferred by the corporation because of the intervention of an event similar in nature to a receivership, within the meaning of Section 107 (d) of the Internal Revenue Code. This holding accords with the statute, the applicable Regulations, and the intent of Congress as expressed in reports concurrent with the enactment of 107 (d). While the statute has but rarely been construed, those cases which have construed it reflect the need for the presence of external control upon a corporation, if the corporate situation is to be considered similar in nature to a receivership. In the case at bar, on the other hand, the restraints imposed on the corporation which operated to defer salary payments to taxpayers were the voluntary restraints of the corporation itself, these being dictated simply by ordinary business prudence. Such restraints of usual commercial prudence are not such as present a situation similar in nature to a receivership.

#### ARGUMENT

##### **The Tax Court Properly Determined That Taxpayers' Salaries Were Not Deferred Because of an Event Similar in Nature to a Receivership**

Under certain circumstances, by application of the provisions of Section 107 (d) of the Internal Revenue Code (Appendix, *infra*), a taxpayer who receives back pay in one year may treat it for taxation as if it had been received in a prior year or years, that is, in the year in which it should have been received. Subsection 107 (d)(2) provides a definition of what shall be considered back pay. The only definition with which

we are concerned herein is that which includes within the definition of back pay, remuneration, including salaries, which would have been received and reported in a prior year except for the intervention of (Appendix, *infra*)—

(i) bankruptcy or receivership of the employer;  
 \* \* \* or (iv) any other event determined to be similar in nature under regulations prescribed by the Commissioner with the approval of the Secretary; \* \* \*.

Concededly, we do not have in the case at bar a bankruptcy or receivership of the Commodore Hotel Company. The question presented here is simply whether payment of taxpayers' salaries was deferred because of an event determined to be similar in nature under Regulations prescribed by the Commissioner. The Tax Court held that no such event was present in the instant case. We believe its determination in this respect correct.

Treasury Regulations 111, Section 29.107-3 (Appendix, *infra*), promulgated under the authority of the statute, provide that—

An event will be considered similar in nature to those events specified in section 107 (d) (2) (A) (i), (ii), and (iii) only if the circumstances are unusual, if they are of the type specified therein, if they operate to defer payments of the remuneration for the services performed, and if payment, except for such circumstances, would have been made prior to the taxable year in which received or accrued.

Examining these Regulations in the light of the instant case, we may concede, *arguendo*, that circumstances operated to defer payment which otherwise would have been made in years prior to the taxable years concerned. But there remains the question of

whether the circumstances are (a) unusual, and (b) of the type specified in Section 107(d)(2)(A). It is our position that the circumstances which operated to defer salary payments to taxpayers were neither unusual nor of the type named in the statute, that is, similar in nature to bankruptcy or receivership.

The Tax Court determined that the circumstances were not similar in nature to bankruptcy or receivership, because the deferment in payment was the result of voluntary restraint of the corporation by itself, as opposed to a restriction imposed by a receivership, stating (R. 96):

we do not perceive in their voluntary restraint any resemblance to the restriction imposed by a receivership. Financial distress would normally induce a corporation's officers to adopt policies more cautious and conservative than those followed under conditions of prosperity, and by their forbearance to deplete corporate funds by salary payments petitioners' officer-shareholders displayed a prudence clearly indicated as necessary by existing circumstances. But the decision was theirs to make, and they made it. Under a receivership the decision would not have been theirs.

In this connection it is well to note the Tax Court's factual finding (R. 89) that—

Pacific refrained from foreclosing on the hotel because its officers felt that the corporation's properties were being capably and honestly handled and that Langer and Lindsey would ultimately work out their difficulties.

Not only was the freedom of choice with taxpayers in their conduct of the corporation's affairs, but theirs remained the freedom because of their omission to abuse it. The lack of restraint under which the corporation operated at the hands of Pacific is exemplified by its



failure to restrict salary payments and also by its failure to protest payment of back salary in better times, when the corporation was heavily in the debt of Pacific. In 1941 the problem of salary payments was first acknowledged between the parties, but even then, in defining net income out of which payments were to be made to Pacific, the corporation was allowed to exclude operating expenses, "including usual and reasonable management charges", which would certainly cover officers' salaries. (R. 89.)

While Section 107 (d) is a relief statute to alleviate the ills of certain taxpayers, it must be borne in mind in construing the requirements of that section that there is a fundamental inhibition in the federal tax laws against the spreading of income. Thus, from taxwise time immemorial, the right has been denied both to the Government and to taxpayers to allocate income to years in which it is not received or accrued; our income tax structure is bottomed upon an annual accounting of income, not upon a haphazard allocation to divers taxable years in order to produce the least—or most—tax. *Security Mills Co. v. Commissioner*, 321 U. S. 281. The congressional reports concurrent with and concerning the passage of 107 (d) do not indicate that Congress had in mind any broad and sweeping exception to the doctrine expressed in the *Security Mills* case. The provision had its genesis in a House of Representatives bill, which allowed the spreading of back pay under certain limited circumstances, such as sums received by individuals because of alleged unfair labor practices under the National Labor Relations Act, or because of a violation of the Fair Labor Standards Act, or by retroactive wage increases afforded by the National War Labor Board. H. Rep. No. 871, 78th Cong., 1st Sess., p. 33 (1944 Cum. Bull. 901, 926). But, because of its limited application, this section did not receive Senate ap-



proval. S. Rep. No. 627, 78th Cong., 1st Sess., p. 22 (1944 Cum. Bull. 973, 990). However, the Conference Committee of the two Houses of Congress agreed on a compromise provision which is now 107 (d). In its report (H. Conference Rep. No. 1079, 78th Cong., 2d Sess., p. 45 (1944 Cum. Bull. 1059, 1062-1063)) the Conference Committee, discussing this provision, stated:

The term [back pay] refers only to remuneration the payment of which has been deferred by reason of the unusual circumstances of the type specified in the definition.

Congressional insistence that the provision applies only in "unusual" circumstances withdraws from the provision any aura of liberal construction. Clearly, a taxpayer, to receive the benefits of the provision, must bring himself within its terms. In effect, the statute provides an exemption and is therefore subject to strict scrutiny. *Smart v. Commissioner*, 152 F. 2d 333 (C. A. 2d), certiorari denied, 327 U. S. 804.

Section 107 (d) has been rarely construed. In *Kenny v. Commissioner*, 4 T. C. 750, taxpayer's employer was required, as a condition of an R.F.C. loan, to defer payment of part of the salaries of certain officers, among them the taxpayer therein. The salary deferred, when paid, was held to be "back pay" within 107 (d). The Tax Court found that the situation was not usual, and further, that the employer was restricted under its agreement with R.F.C. in ways which resembled the restrictions placed upon business operations conducted under receivership. That case the Tax Court distinguished in the case at bar, on the ground that the deferment of payment by the corporation herein was its voluntary act. Thus a situation is presented which is different from that in *Kenny*, wherein the court stated that its holding was premised (p. 755) "upon the conclusion that the restrictions on salary payments made by R.F.C.

resemble the restrictions imposed by a receiver." We believe that the Tax Court properly distinguished the *Kenny* case from the situation at bar.

In *Dean v. Commissioner*, 10 T.C. 672, taxpayer's employer deferred payment of incentive pay because a ruling of the Salary Stabilization Unit of the Bureau of Internal Revenue inhibited payment. When a subsequent ruling reversed the Unit's position, payment of the deferred amounts was made. The Tax Court held that this payment came within the definition of the payment of back pay as defined in 107 (d).

Both the *Dean* and *Kenny* cases were reviewed by the entire Tax Court as was the instant case, but no appeal was taken in either of the former. It is clear from both that an element present in them, but which is lacking herein and the presence of which was considered of utmost importance in the *Kenny* case, is a control over the employer preventing the payment of salaries in the normal course of events, as opposed to the voluntary restraint imposed on itself by the corporate employer in the case at bar, however prudent that restraint may have been. Taxpayers (Br. 21-23) argue that the corporation was under such control as is necessary to satisfy the statute. But this argument is defeated by the words of Pacific's loan officer (R. 89, 96), to the effect that the corporation was generally left to its own devices because it was in capable hands. This is hardly the control comparable to that wielded by a receiver or over a corporation in a situation similar in nature to a receivership. Not only did Pacific not control the corporation, it paid its taxes and relieved it of some of its loan obligations to assist the operation by corporate officers. (R. 88-89.) Pacific's attitude of inaction and satisfaction with the corporation's administration is diametrically opposed to the restraints of receivership or some unnamed similar proceeding.

Taxpayers argue (Br. 15)—

For all practical purposes, Commodore [the corporation] was in the hands of its principal creditor, and was operating subject to its close supervision and control.

We submit, on the contrary, that the record shows exactly the opposite, that for all practical purposes the corporation was accorded full freedom of action by Pacific. In this conclusion, we are supported by the Tax Court's conclusions below.

The facts at bar indicate, in fact, that this is merely the *usual* case of a corporation, not the unusual as demanded by the statute, where in bad times salaries are deferred and the earners thereof are subsequently reimbursed in later, more prosperous years. In such a situation, the payments should be considered those of the year of payment. Cf. *Lucas v. Ox Fibre Brush Co.*, 281 U. S. 115. Not only was the situation at bar usual in commercial practice, the facts do not reveal a situation similar in nature to a receivership. Accordingly, the Tax Court's decision should be affirmed.

If, however, this Court should deem the decisions below erroneous, we contend that the case should be returned to the Tax Court for a determination on the other two grounds proposed by the Commissioner below to justify his determination of deficiency, namely, that taxpayers have not shown that the so-called back pay received in the taxable years exceeded fifteen per centum of the gross income of each for such years, within the meaning of Section 107 (d)(1), and that, in any event, no salaries were authorized after 1937, and the corporation was under no obligation to pay up the sums deferred. The Tax Court (R. 97) found it unnecessary to reach these two propositions, and its findings of fact are not sufficient for this Court to base a determination thereon. Accordingly, if it be de-

terminated that taxpayers received the amounts involved in an unusual situation in the nature of a receivership, the case should be returned to the Tax Court to find facts upon which a decision can be made as to the Commissioner's alternative arguments. *Commissioner v. Stinchfield's Estate*, 161 F. 2d 555 (C.A. 9th); *Lewis v. Commissioner*, 160 F. 2d 839 (C.A. 1st); *Diller v. Commissioner*, 91 F. 2d 194 (C. A. 9th).

#### CONCLUSION

In view of the foregoing, it is submitted that since the Tax Court has committed no error either in law or in fact, its decisions should be affirmed.

Respectfully submitted,

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APRIL, 1950.



## APPENDIX

## Internal Revenue Code:

SEC. 107 [As added by Sec. 220(a) of the Revenue Act of 1939, c. 247, 53 Stat. 862]. COMPENSATION FOR SERVICES RENDERED FOR A PERIOD OF FIVE YEARS OR MORE.

\* \* \* \* \*

(d) [As added by Sec. 119 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21] BACK PAY.—

(1) *In General*.—If the amount of the back pay received or accrued by an individual during the taxable year exceeds 15 per centum of the gross income of the individual for such year, the part of the tax attributable to the inclusion of such back pay in gross income for the taxable year shall not be greater than the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for the taxable years to which such portions are respectively attributable, as determined under regulations prescribed by the Commissioner with the approval of the Secretary.

(2) *Definition of Back Pay*.—For the purposes of this subsection, “back pay” means (A) remuneration, including wages, salaries, retirement pay, and other similar compensation, which is received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year except for the intervention of one of the following events: (i) bankruptcy or receivership of the employer; (ii) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings; (iii) if the employer is the United States, a State, a Territory, or any political subdivision thereof,



or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (iv) any other event determined to be similar in nature under regulations prescribed by the Commissioner with the approval of the Secretary; and (B) wages or salaries which are received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which constitute retroactive wage or salary increases ordered, recommended, or approved by any Federal or State agency, and made retroactive to any period prior to the taxable year; and (C) payments which are received or accrued during the taxable year as the result of an alleged violation by an employer of any State or Federal law relating to labor standards or practices, and which are determined under regulations prescribed by the Commissioner with the approval of the Secretary to be attributable to a prior taxable year. Amounts not includible in gross income under this chapter shall not constitute "back pay".

(26 U.S.C. 1946 ed., Sec. 107.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.107-3 [As added by T.D. 5389, 1944 Cum. Bull. 196]. BACK PAY ATTRIBUTABLE TO PRIOR TAXABLE YEARS.—Section 107 (d)(2) defines "back pay" and section 107 (d)(1) limits the amount of tax resulting from the inclusion of such back pay in gross income for the year in which it is received or accrued. Back pay includes compensation for wages, salaries, pensions, and retirement pay received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year but for the intervention of any one of the follow-

ing events: (1) bankruptcy or receivership of the employer; (2) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings; (3) if the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (4) any other event determined to be similar in nature under these regulations. As to what constitutes bankruptcy and receivership proceedings see section 29.274-1.

An event will be considered similar in nature to those events specified in section 107 (d) (2) (A) (i), (ii), and (iii) only if the circumstances are unusual, if they are of the type specified therein, if they operate to defer payments of the remuneration for the services performed, and if payment, except for such circumstances, would have been made prior to the taxable year in which received or accrued. For the purposes of this section the term "back pay" does not include remuneration which is deemed to be constructively received in the taxable year or years in which the services were performed, remuneration paid in the current year in accordance with the usual practice or custom of the employer even though received in respect of services performed in a prior year or years, additional compensation for past services where there was no prior agreement or legal obligation to pay such additional compensation, or any amount which is not includible in gross income under Chapter 1.

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